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Tros Tyriusque mihi nullo discrimine agetur

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THE TAX SITUATION

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THE subject of taxation has again been thrust into the forefront of public discussion. So numerous and so complicated are the problems connected with immediate reform that it may be helpful to refresh our recollection as to the fundamental principles, with a view to ascertain what are the practical applications.

The experience of the last century or two since the advent of modern democracy and the attendant economic changes have resulted in the tacit acceptance by all civilized nations of certain outstanding principles or canons of taxation. Although they have hitherto not been formulated in precisely the following way, it may be well to recall them to mind.

Since the paramount object of taxation is to secure revenue, taxation may first be regarded from the fiscal point of view. This fiscal criterion leads to what may be termed the principle of productivity. A tax that is designed to raise revenue will clearly be a failure if it is not adequate. The meagreness of the yield may be due not only to the fact that the tax sins against the administrative and economic principles to be mentioned in a moment, but to a certain inherent maladjustment of the tax to the general environment. Furthermore, the productivity of a tax often depends upon its elasticity, that is, the responsiveness of its yield to a change in the rate. As Dean Swift put it: "In the arithmetic of customs, two and two does not always make four."

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At the present time, these canons of adequacy and elasticity are violated in several ways. Some of what the Secretary of the Treasury calls our "nuisance taxes" yield entirely too slight a revenue to warrant their continuance; while, on the other hand, the extremely high surtaxes in the income tax have so obviously exceeded the maximum revenue point as to call for a reduction of the rate in order to increase the yield.

In the next place, tax laws, like all others, will necessarily be open to criticism if they are not properly administered. The administrative criterion results in the principle of efficiency; and this may disclose itself in three ways. First, we need certainty of taxation: if the law be uncertain, it will necessarily be inefficient in its operation. Second, we need economy of taxation, that is an economical adjustment of yield to efforts: if the tax costs an inordinate amount to collect, it represents an administrative inefficiency the very opposite of economy. Third, the tax should be so administered as to involve the least possible inconvenience to the taxpayer.

The certainty of taxation is a canon that is frequently violated owing to the proverbial weakness of administration in democratic countries. Apart from the problems connected with our customs tariff legislation, perhaps the best recent examples of uncertainty are to be found in the excess-profits tax and in certain parts of the federal income tax. The uncertainty of many provisions of the laws has been only in part removed by administrative rulings and judicial decisions. Arbitrariness in taxation is almost the greatest enemy that the taxpayer has to encounter.

Again, the economy of taxation depends primarily on the cost of collection; and this is influenced not only by the nature of the tax, but by the reaction of the community to the tax. Certain taxes are proverbially difficult to collect. The expense of administering the tax on spirituous liquors in the United States, where moonshining was prevalent, was notorious. The repugnance of the British property owner to the land taxes introduced by Lloyd George's famous budget was so pronounced that in certain cases the cost of collection actually exceeded the revenue, with the result that all attempts to enforce the tax were abandoned in 1920. Perhaps the most striking illustration is afforded

by the contrast between what is sometimes called concentrated taxes as against diffused taxes. When Gladstone came to power he found taxes on what someone wittily described as "everything that one sees, feels, smells, or hears." His life work as a financier consisted primarily in reducing this heterogeneous system to a very few taxes on articles of wide, but not necessary, consumption, thus securing an immense revenue at very little expense. A tax on spirits, on tobacco, or on gasolene is worth hundreds of taxes on multitudinous articles where the difficulties of collection are considerable. The economy of taxation is a canon not to be neglected.

Thirdly, convenience in taxation has several aspects which often become of great practical consequence. The problem of how the tax is to be paid raises such a question as that of the use of stamps. The problem of when the tax should be paid involves the desirability of the instalment system. The problem of how or under what conditions the tax is to be paid may often make the difference between success or failure. Thus the canons of certainty, economy, and convenience are all important corollaries of the administrative principle of efficiency.

A more significant problem, however, is that of the immediate or ultimate effects of taxation on the economic situation as a whole. It is the function of the wise legislator to have taxation interfere as little as possible with the general prosperity of the community. As over against the purely fiscal or administrative criteria which we have been discussing, the economic criterion leads to what may be called the principle of prosperity. The interference with the normal phenomena of economic life may indeed sometimes be designed, as when a tax, like that on child labor, is levied for a purely social purpose. But such interference is from the very nature of the case presumed to conduce to the larger prosperity of the community. What we must guard against is not so much interference, as harmful interference, with the normal processes of economic life. If the unexpected consequence of a tax is to injure the prosperity of the community, the more efficiently it is administered the worse it becomes. Since it is important that taxes should interfere as little with the prosperity of the community and should be as harmless or

innocuous as possible, the principle of prosperity leads to the canon of harmlessness or innocuity of taxation. Perhaps the most serious danger of modern taxation resides in this unanticipated interference with the normal economic phenomena. Especially is this true in recent times where the injurious results show themselves primarily in the consequences of excessive taxation. Were there space to dwell upon this phase of the subject, it would be easy to call attention to the harm done either directly to production, exchange, or consumption, or more indirectly to the long-time economic interests of the community.

Everyone is familiar with the statement made by the Secretary of the Treasury as to the harmful results of the excess-profits tax. In its effects upon production and enterprise, it can be compared only to some of the mediaeval taxes on consumption. If a tax limits enterprise and retards production, it will tend to decrease the national dividend and to carry with it unlooked-for consequences in the reduction of wages and the diminution of social progress. Even if we cannot reasonably demand that a tax should directly increase prosperity, we have, at all events, every right to ask that it should not injure the community. If the proceeds of an otherwise unexceptionable tax are spent economically on something that the community needs, the net result ought to be of no harm to the community. Innocuity or harmlessness of taxation is an especially important canon at the present time, when the fiscal burdens have become so heavy.

All these canons of taxation may, however, be deemed to be secondary, compared with the fact that when we consider the relation of taxation to individuals as a class rather than to any single member of the class, it becomes necessary to apply the ethical criterion. Even though the tax system may be satisfactory in its yield, its administration, and in its general economic effects, it would still be open to criticism if it failed to meet the demands of justice as among individuals or classes. The criterion of fundamental importance in any system of taxation is the ethical criterion, because in fiscal as in all economic relations, the paramount question is that of justice. If individuals are to be called upon to the support of the state, and especially if the contribution is a compulsory one, they cannot escape

emphasizing the equitable character of the contribution. Especially in a democratic community does this ethical criterion result in the demand for equality of treatment. However successful a tax may be in other respects, if it sins in this particular, it will sooner or later be swept away. Equality of taxation is the very cornerstone of all tax programmes.

Equality of taxation, however, has two implications. If individuals are to be taxed equally, it follows in the first place that all must be taxed. The canon of universality of taxation is therefore the first corollary of the principle of equality. The history of taxation marks a continual struggle to realize the universality of taxation. From the very beginning, exemptions and immunities of all kinds were secured by the powerful, and the struggle of democracy may often be put in terms of the attempt to abolish unjust privileges and immunities. The French Revolution itself is largely explicable from this point of view.

At the present time, in the United States as elsewhere, most of these old class and individual exemptions have been abolished. But there still remains a system of exemption which has its origin in a much more specious and ostensibly legitimate situation. The chief problem of modern immunity is that of the exemption of Government securities. In the United States this takes two forms: exemption of securities in general, and exemption of securities issued by one kind of government from taxation imposed by another kind, as, for instance, the Federal, the State, and the local Government. So far as the latter form of immunity is concerned, the historical reasons which at one time made it desirable to free State and local securities and salaries from taxation by the Federal Government no longer apply. The continued exemption of billions of State and local securities is scarcely defensible from any point of view. So far as the exemption of federal securities from federal taxation is concerned, the problem is somewhat more involved. From the point of view of principle, there is always a possible choice between upholding the credit of a government and securing equality of taxation. That is to say, if it becomes a matter of life or death with the State in a great emergency to market its securities at a reasonable rate, the exemption from taxation may be a cheap price to pay.

If we have to choose between political existence and economic equality, the latter will have to give way. But in the United States, when our existing debt was created there was no such alternative. It was simply a question of issuing the Liberty or Victory Loans at a higher rate of interest. We sacrificed equality of taxation not to fundamental necessity, but to ephemeral convenience. While it is true that the holders of exempt securities do not entirely escape taxation—for when they purchase the bonds they pay somewhat more for them, and when they receive interest they get a somewhat smaller amount—yet not only is the correspondence by no means complete, but there is in addition a feeling on the part of the non-exempt members of the community that a privileged class is growing up among them. One of the chief reasons, for instance, why the higher brackets of our income tax are yielding continually smaller revenues is because of the temptation on the part of the wealthy to invest in tax-exempt securities. As a result of our system not only does the Government lose hundreds of millions in annual revenue, but the income tax, instead of being borne primarily by those who can afford to pay, is borne primarily by the unwary and those who find it difficult to convert the sources of their income into tax-exempt securities. The actual derogation from the principle of universality of taxation at the present time in the United States is perhaps the chief indictment of the entire Federal system. The elimination of our present forms of exemption is the most crying demand of reform.

Equality of taxation has, however, another implication. Equality does not mean absolute numerical equality. If the millionaire and the pauper were each taxed $100 there would be absolute numerical equality, but surely no justice. By equality we must therefore mean a relative equality or relatively proportional equality. For such equality we have the term uniformity. The second canon of taxation which flows from the principle of equality is accordingly uniformity of taxation.

Since uniformity means relative or proportional equality, the problem arises as to the nature of the relation involved in this idea of proportion. For the relative equality implied in uniformity must be expressed in terms of such a relation. With-

out going into the recondite aspects of this subject, which has much exercised fiscal and economic students, it may be said that the modern democratic theory as to the criterion to be employed in ascertaining the true basis of taxation is the faculty or ability theory. This demands that every individual should be held to pay taxes in proportion to his faculty or taxable capacity. Since the individual has to turn over to the State some form of wealth, the considerations that are pertinent to the problem in each case revolve around the three questions: (1) How does he get the wealth? (2) What kind of wealth is it? (3) What does he do with the wealth? In other words, we have to treat of the acquisition of wealth, the possession of wealth, and the disposition of wealth. In dealing with the acquisition of wealth, we have to consider the cost of acquisition; in dealing with the disposition of wealth, we have to weigh the sacrifice of consumption; and in dealing with the possession of wealth, we are confronted by the elements of social privilege. How to measure these various factors and how to ascertain the particular test to be employed in comparing the faculty of one individual with that of another involves the chief practical problem in endeavoring to realize the principle of uniformity of taxation.

Historically, many attempts have been made. Without going into the history of the subject, it may be said that at the present time the choice in all democratic societies lies between expenditure or consumption on the one hand, and property or income on the other hand; with a further selection between property and income as the best indication of wealth.

The distinction just alluded to is in harmony with the modern and more approved methods of classifying taxes. The old division into direct and indirect taxes, which is still popularly followed, has been repeatedly shown to be of little scientific value. Direct taxes are supposed to be those which remain as a burden on the people who pay them; indirect taxes are supposed to be those that are shifted to someone else. Unfortunately, this criterion is no longer valid, as the shiftability of the tax often depends more upon the way in which it is levied than upon the character of the tax itself. Many so-called direct taxes are not infrequently shifted.

A more scientific classification is that based upon the criterion of stages in the economic process. If we trace the steps in the economic life of an individual we find that after acquiring economic goods, whether by production or otherwise, he either exchanges or consumes them. That is to say, the four stages in the process of wealth are acquisition, possession, exchange, and consumption. Since, however, everything that is possessed must be acquired in some way, the characteristics of acquisition and possession are so similar as to warrant their inclusion in the same category. Taxes might then profitably be classified into taxes on wealth, as measured by the income or the property of the individual, and taxes on expenditure as manifested in either consumption or exchange. The latter class would include what are ordinarily called on the one hand taxes on transactions and communications and, on the other, taxes on commodities. In still rougher terms, we could put the contrast between taxes on wealth and taxes on expenditure.

Expenditure has not infrequently been advanced as the test of faculty and as constituting the real norm of taxation. As soon as private property developed, it became easy to raise money by levying taxes on commodities. It is true that in the beginning the idea of ability played only an insignificant rôle. But later on, when the system of direct taxes had been honeycombed with all manner of abuses, the tax reformers advanced expenditure as the best means of reintroducing the sadly lacking equality. Inasmuch as everybody has to spend money, a tax on expenditure would permit no one to escape, and since the wealthy always spend more than the poor, a tax on expenditure was deemed to be a far better approach to the principle of ability to pay than could be found in the then existing medley of taxation. The demand for the general excise soon became the rallying cry of tax reformers throughout Europe.

As a matter of fact, however, the reason why the property tax of the time failed, was not because property constituted an unsatisfactory norm of taxation, but because certain classes or individuals were *not* taxed on their property. It was exemption, rather than taxation, which was at the root of the difficulty. Indeed, when taxes on expenditure developed, it soon became

clear that expenditure is not a satisfactory criterion of faculty. In the first place, some individuals must consume all that they produce, while others spend only a small part of the wealth that they acquire. While it is a fact that the rich man will spend more than the poor man, it is none the less true that in proportion as we approach the category of necessary expenditures, this difference tends to vanish. To the extent that expenditure deals with necessaries or even with comforts, taxes on expenditure impose a relatively greater burden on the poor. This has been so universally recognized that well-nigh every democratic movement in taxation has taken the form of an attempt to reduce taxation on expenditure.

Secondly, from a wider economic point of view, expenditure is an unsatisfactory test, because in normal economic life the best way to secure the social surplus which forms the basis of civilization is to increase production, rather than to decrease consumption. Productive consumption is a necessary and salutary part of the economic process. To check consumption is suicidal.

While expenditure in general cannot be accepted as a criterion of faculty, certain forms of consumption taxes, however, may be utilized to round out other elements of ability to pay. While it is not true that high-priced articles are exclusively purchased by the rich or that low-priced articles are bought only by the poor, it remains a fact that a tax on luxurious expenditure is normally borne by those who think that they can afford to purchase luxuries. The tax on luxuries is therefore not open to the objections advanced against a general tax on expenditure. Secondly, the Government may desire as a social policy to restrict the consumption of certain quasi-luxuries, like liquors or tobacco or gasolene. A tax on such forms of expenditure might be conceived as a tax on what an individual ought to be able to spend for such purposes; in which case it might be considered as a tax not so much on actual ability to pay, as on putative or socially desirable ability to pay. Finally, certain taxes on exchange or consumption are so lucrative that they tend to diminish the burden of taxes on wealth which, when pushed beyond a certain point, may tend to become economically harmful. Expenditure may in this way

serve as a means of securing a more well-balanced system of taxation.

But in the main the response to the demand for equality of taxation took the form of a tax on wealth. In one shape or another the general property tax became the backbone of the entire tax system, and in the greater part of the United States to-day this is still the case in State and local taxation.

In recent years, however, several shortcomings have disclosed themselves in the system of property taxation. Under modern conditions, with their speculative characteristics and cyclical movements, there is often a disparity between the property and its yield or produce. Furthermore, a property tax is coming more and more to be a tax on savings. To the extent that we tax property which has been accumulated through savings, we put a premium upon extravagant expenditure. Such a tax becomes in a certain sense anti-social in character and to be deprecated from a general economic standpoint. Again, the acceptance of property as a criterion of taxable ability becomes more and more unsatisfactory under conditions where large professional incomes or salaries, which would otherwise entirely escape taxation, are customary. Finally, modern business methods impair the value of property as the norm of taxation. When merchants' stocks were relatively small and the turnover moderate, it was feasible to measure a merchant's ability to pay by the property invested in business; nowadays, it is not what merchants have, but what they make, that is of importance; and what they earn depends upon many factors other than the amount of their capital or stock in trade.

It is for the above reasons that property is gradually disappearing as the best criterion of ability to pay, although there is still considerable scope for its retention in cases where, as in real estate, property rapidly reflects in its capital value changes in its earning capacity, where the property is subject to every-day sale, where it is held simply for enjoyment without affording a money income, and where the yield of the property may stop for a time, while its market value is still appreciable.

With these exceptions, however, the modern world has come to the conclusion that income is on the whole a more satisfactory

norm of taxation than any of the others that have been mentioned. A careful analysis, however, would show that income is also not without its weaknesses as an ideal criterion. These weaknesses may be declared to be the vagueness of the conception in income, the inadequacy to reflect all of the normal elements of faculty, and the failure to consider the influence of other factors than those of acquisition.

The first difficulty is apparent at the present time in the United States. Does income include only money income, or also money's worth, like the rent of a house? Does income mean only regular and periodic proceeds or does it comprise chance or aleatory receipts, like gifts? Can income be clearly differentiated from capital, and does all accretion to capital, like the appreciation of securities, constitute income? If stock dividends are not income, are dividends distributed in the form of bonds, income?

But even if we knew precisely what income is, does it include all the important criteria of faculty? Let us take two contrasted cases. On the one hand, there is a bachelor physician, without dependents, living in a small town, in robust health, but penurious to the last degree. In contrast to him is his fellow practitioner with the same income, but married, with a large family, under the obligation to support his parents, living in an expensive apartment in a large city, in more or less precarious health, and yet generous to a fault in the support of communal and other public purposes. Can it properly be held that these two individuals ought to be taxed identically the same amount because their incomes are the same?

With all its shortcomings, however, income constitutes the best norm that we can devise, and it explains why in the Great War the backbone of our fiscal system was composed of income and profits taxes, whereas a century ago in the war with Great Britain we relied on a property tax, rather than an income tax. It also explains why in so many of our States and cities, where the old general property tax has been breaking down, we find the recent development of income taxes and of business taxes levied according to the criterion of earnings or profits.

The practical conclusions applicable to our present situation are not difficult to draw. In the first place, the needs of govern-

mental economy and efficiency are paramount. Unless the total expenditures are reduced to manageable proportions, no system of taxation that might be devised can fail to be burdensome and injurious. Expenditures must always bear a certain proportion to the social income. Where taxes are made to trench unduly upon the social income, they will react upon both consumption and production, and, except in the very unlikely event that the Government spends its money in a more economical and efficient way than private individuals would do, it is bound to retard economic development. Excessive taxes, no matter how levied, are injurious.

Secondly, care must be taken to preserve the balance between taxes on wealth and taxes on expenditure, with the understanding that, inasmuch as wealth forms a relatively better criterion of ability to pay than expenditure, the larger share of the taxes should come from wealth. Since the opening of the Great War, however, the proper balance has not been kept. From three-quarters to four-fifths of all of our Federal revenues have been derived from taxes on wealth. If to this we add about nine-tenths of the State and local taxes, which are almost exclusively levied on wealth, it is not surprising that the strain has become too great. Our excess-profits tax has already broken down and our income tax is in danger of following suit. Not only is the revenue declining, but the regrettable consequences upon business and enterprise are only too apparent. The taxes on wealth should be reduced. This means that the excess-profits tax must be eliminated, and the higher brackets of surtax in the income tax be reduced.

On the other hand, we must be careful not to go too far in the other direction. The proposal of a general sales tax is unwise for several reasons fiscal and administrative, but chiefly because it would unduly depress the balance in the other direction, and cause the major part of our national revenues to be derived from taxes on necessary consumption. The sales tax is virtually an inverted or upside-down income tax. It puts the burden where it can least be borne, and it prevents the utilization of the graduated feature which has become an indispensable accompaniment of all income taxes. The sales tax is not an Anglo-Saxon but

a Latin-American device, and it is essentially repugnant to the instincts of a democratic community.

Above all, the demand for a somewhat greater reliance upon expenditure taxes can be met in a far better way. As we have already noted, the approved modern system of expenditure taxes is one of concentrated rather than of diffused taxes. This means in practice a system of taxes on the conveniences of life such as tobacco, gasolene, stamped paper, and the like, together with the taxes on transportation, admissions, automobiles, etc. If still further taxes on expenditure seem desirable, let them be imposed upon articles of luxury like jewelry, fine clothing, and the like, as is in part already now done, although with inadequate attention paid to cases of unnecessary discrimination. But let us not revert to the Middle Ages, with its taxes on salt and its taxes on bread. Finally, if there is danger of the taxes on expenditure trenching on the line which separates necessities and elementary comforts from luxuries, let us add to the somewhat reduced taxes on income a tax on business which will reach the wealth of the country when it is actually being distributed and which will be so moderate as not to interfere materially with the accumulation of capital or the development of enterprise.

Above all, let us endeavor to rid ourselves of the one crying evil of our present system—the inequality inherent in the unjustifiable exemption of Federal, State, and local securities. Let us be mindful of the basic principles of taxation. Let us abandon the "nuisance" taxes which yield but little revenue. Let us relinquish the taxes like the excess-profits tax which sins against the administrative canons of certainty, economy and efficiency. Let us beware of securing revenue at the expense of restricting either consumption or production. But above all, let us attempt to realize the fundamental canons of uniformity and equality of taxation.

Congress has an admirable opportunity presented to it. Let us hope that it will rise to the opportunity and provide us with a fiscal system in peace times which will be as successful, and on the whole as defensible, as that which was created in war times.

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